The magnitude of the outperformance is striking. Cohen et al. (2010) found that, between 1984 and 2007, mutual fund managers’ best ideas—the ideas in which they had the greatest conviction—outperformed the market by about 1–2.5 percent per quarter, depending upon the benchmark. Cohen et al. (2010) is quoted as saying that best ideas generated:

“… statistically and economically significant risk-adjusted returns over time but they also systematically outperform the rest of the positions in managers’ portfolios. We find this result across all combinations of specifications: different benchmarks, different risk models, and different definitions of best ideas.”

In addition to providing a brief overview of academic findings, this article explores the advantages enjoyed by focused fund managers, examines the reasons focused funds are not more widely adopted in the mutual fund industry, and provides some recommendations for investment advisors to consider.

High-Conviction Investments Have Outperformed

Most mutual fund managers will acknowledge that they have greater conviction in their top five investment ideas than in ideas 25 through 100. It’s interesting to learn, then, that research shows managers’ best ideas systematically outperform other positions in their portfolios as well as the market.

High-conviction investments have outperformed: The highest-conviction ideas of typical active mutual fund managers consistently outperformed the rest of the positions in their portfolios, and the market, by about 1–2.5 percent per quarter, depending upon the benchmark (Cohen et al. 2010).

Highly concentrated funds have outperformed: Fund managers who concentrate portfolio assets in their highest-conviction ideas outperformed managers of more highly diversified portfolios over a 24-year period (Baks et al. 2007).

Focused funds have not had higher risk: Portfolios that included only managers’ best ideas generally delivered strong returns without added risk (Baks et al. 2007).
**Highly Concentrated Funds Have Outperformed**

Not all mutual fund managers are willing to concentrate their portfolios’ assets in a few good ideas. Those who do, however, have the potential to outperform the market as well as more-highly diversified mutual funds. Baks et al. (2007) found that domestic stock portfolios with strong weightings in a relatively small number of holdings delivered higher returns—both before and after expenses—than portfolios that held more-uniformly weighted positions. These focused portfolios delivered approximately 30 basis points of additional performance each month, or roughly 4 percentage points of additional return each year (Cohen et al. 2010).

**Focused Funds Have Not Had Higher Risk**

Many financial professionals were taught that concentrated mutual funds expose investors to greater risk than more-highly diversified options. Generally, this is not the case. Research shows that holding 20 to 50 stocks can reduce unsystematic risk significantly (Campbell et al. 2001). This concept is illustrated in figure 2.

In late 2009, the *Wall Street Journal* published an article that included research from Morningstar, Inc., which demonstrated that mutual fund portfolios with 40 or fewer holdings “aren’t more volatile than more diversified funds, on average, and some are surprisingly steady despite their small number of holdings” (Light 2009).

In a separate study, Morningstar analyzed the standard deviation of the most diverse and the most concentrated mutual fund portfolios between 1992 and 2006 (Light 2009). Their work showed that volatility was similar for the two groups, refuting the idea that concentrated portfolios, as a whole, are riskier than more diversified offerings.

**The Structural Advantages of a Focused Approach**

Academic research shows that focused mutual funds have the potential to produce strong returns without added risk—but a key question is why? The answer may be quite simple. Focused funds hold fewer stocks than typical mutual funds, so focused fund managers have more time to research and understand the stocks they hold or are considering adding. This should give focused fund managers informational advantages that may aid in the identification of mispriced securities. Focused fund managers also can be more discriminating, avoiding stocks or sectors that they do not like, and focusing attention on a narrow band of companies or securities that meet their strict criteria.

In his 1993 letter to shareholders, Warren Buffett described the logic of his philosophy—and that of many focused fund managers when he said:

“Charlie and I decided long ago that in an investment lifetime it’s just too hard to make hundreds of smart decisions … Therefore, we adopted a strategy that required our being smart—and not too smart at that—only a very few times. Indeed, we’ll now settle for one good idea a year… The strategy we’ve adopted precludes our following standard diversification dogma…. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort-level he must feel with its economic characteristics before buying into it” (Buffett 1993).

Research Provides Evidentiary Support

It makes intuitive sense that better information may produce benefits for investors, and academic research supports this idea as well. It suggests that focused fund managers...
are more confident and have longer-term outlooks.

Information advantages: In general, managers who hold fewer companies have more time and greater incentive to develop complete information about each company in which they invest. Kaperczyk and Seru (2007) found that managers who rely less on public information when making buy and sell decisions deliver significantly higher returns.

More confident stock selection: Baks et al. (2007) found that managers who invested a disproportionate amount of assets in their best ideas were confident about their ability to assess the merits of investment options both inside and outside of their portfolios.

A long-term outlook: Kaperczyk et al. (2005) found that managers of concentrated portfolios are able to add value by exploiting long-term mispricings in the marketplace. As a result, they delivered strong performance with lower turnover during the 24-year period studied.

Why Isn’t Focused Investing the Industry Standard?
Cohen et al. (2010, 1) showed that “the typical fund manager has a small number of good investment ideas that provide positive alpha … the remaining ideas in the typical managed portfolio add no alpha at all.” This begs the question: “Why do managers include investments that are not best ideas in their portfolios?” There are a variety of explanations.

Flawed financial incentives: In general, mutual fund managers are paid a fixed percentage of total assets under management. This creates an incentive for managers to emphasize growth in fund assets over performance. Because investors tend to stay in mutual funds even when they deliver mediocre performance, few managers are willing to turn away new investors when cash inflows are more plentiful than high-conviction investment ideas (Sirri and Tufano 1998).

Career risk: John Maynard Keynes observed, “Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.” Managers who underperform their benchmarks for any one- or two-year period may face the threat of termination. As a result, many managers have incentives to avoid unsystematic risk, as well as a tendency to herd into popular sectors (Chevalier and Ellison 1998).

Legal and regulatory requirements: The Prudent Man Rule makes it attractive for portfolio managers to have well-diversified portfolios. Prudent protection of capital necessitates the avoidance of unwarranted risk (Baks et al. 2007). In addition, mutual fund managers are guided by specific regulations designed to prevent mutual fund assets from becoming too concentrated (Cohen et al. 2010). As a result, managers cannot invest an unlimited amount of assets in a few holdings.

Managers who have the incentives, confidence, and ability to concentrate assets in their best ideas provide attractive opportunities for investment advisors seeking value-added active portfolio management.

Utilizing Focused Funds
Concentrated portfolios have potential to deliver outperformance without increasing risk, but consider the following:

- Because best ideas tend to be smaller and less liquid, focused portfolios may be less nimble. Therefore, investors should plan to hold focused funds for longer periods of time.
- Concentrated portfolios may have little or no exposure to certain market sectors. Consequently, if a sector in which the fund has little exposure gets hot, a concentrated portfolio may lag its benchmark for a period of time.
- The movement of a single stock in a positive or negative direction—based on rational or irrational investor behavior—may have a greater effect on a more concentrated portfolio.

Although these characteristics are unlikely to have long-lasting effects on performance, they may have a significant influence over shorter periods of time. As a result, more concentrated funds generally should be longer-term portfolio holdings.

Consider Using Focused Funds as Satellites or Alternatives to Core Holdings
Advisors who are looking for ways to improve performance potential may want to consider incorporating focused funds into their asset allocation strategies. Focused funds may be used as:

**Figure 3: Fund Managers’ Best Ideas Rarely Overlap**

![Figure 3: Fund Managers’ Best Ideas Rarely Overlap](image-url)

<table>
<thead>
<tr>
<th>Number of managers considering a particular stock idea</th>
<th>Percentage of best ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.7</td>
</tr>
<tr>
<td>2</td>
<td>0.6</td>
</tr>
<tr>
<td>3</td>
<td>0.5</td>
</tr>
<tr>
<td>4</td>
<td>0.4</td>
</tr>
<tr>
<td>5</td>
<td>0.3</td>
</tr>
<tr>
<td>&gt;5</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Mutual fund managers’ best ideas tend to be distinct. Over a 23-year period, about 62 percent of best ideas were unique to one manager, while just 7 percent were shared by five or more managers.

Source: Cohen et al. (2010)
Satellite holdings: A single focused fund may be used as a satellite holding to boost portfolio performance potential. Cohen et al. (2010) found that putting a modest percentage of assets in a concentrated mutual fund of best ideas was likely to improve performance potential.

Core replacement options: Because portfolio managers’ best ideas rarely overlap, several focused funds can be used in place of one highly diversified core fund to improve performance potential without increasing risk (Cohen et al. 2010; see figure 3, this article). Baks et al. (2007) also provides support for the idea of replacing a highly diversified core holding with several focused funds: It concluded that investing in portfolios of focused funds, instead of more highly diversified funds, could enhance overall portfolio performance.

Final Thoughts
Conventional wisdom comprises beliefs that generally are accepted by a group of people. Once these beliefs become ingrained, few take the time to evaluate their substance. In the investment industry, conventional wisdom tells us that highly diversified mutual funds have the greatest potential to deliver attractive risk-adjusted returns. The review of research, however, shows that a more unconventional approach to mutual fund management—concentrating assets in managers’ best ideas—has the potential to provide investors with better risk-adjusted returns.

References


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